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IFRS 17 Update and Reinsurance Deep-dive

Alice Boreman (EY) and Jamie Grant (Lancashire Group) on behalf of the IFoA IFRS 17 for General Insurance Working Party

24 September 2019

Workshop objectives

- This session will :
  - Provide an update on IFRS 17 and the recently proposed amendments;
  - Spotlight the complexity regarding Reinsurance:
    - Contract Boundary
    - Measurement
    - Presentation and accounting

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IFRS 17 Update

Where are we now?

IFRS 17: current status of the Standard

18 May 2017
IFRS 17 standard issued

Feb 2018 – Apr 2019
IASB Transition Resource Group (TRG)

Exposure draft (ED) issued June 2019

Comment and analysis of ED

New standard expected mid-2020

Tentative decision to delay by one year

January 2021
IFRS 17 effective date

January 2022
IFRS 17 effective date (revised)

2017 **2018** **2019** **2020** **2021** **2022**

IASB decisions on amendments to IFRS 17

Discussions with IASB on issues not addressed (e.g non-prop RI)

Oct 2018 – Apr 2019

EU endorsement expected…

…or UK Accounting Standards Endorsement Board

FY2022: First full year reporting under IFRS 17

Key amendments that impact GI

- One year delay in effective date
- Aggregation of assets and liabilities on the balance sheet
- Treatment of proportionate reinsurance held covering onerous contracts
- Treatment of claims acquired in their settlement period on transition

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The IASB have proposed 8 major amendments

1	2	3	4
★ **Deferral of effective date by one year** IFRS 17 IFRS 9	★ **Allocation of acquisition costs to expected contract renewals**	**Attribution of profit to service relating to investment activities**	**Extension of risk mitigation option**
5	**6**	**7**	**8**
★ **Reduced accounting mismatches for reinsurance held**	★ **Simplified balance sheet presentation**	★ **Additional transition reliefs** Contracts acquired in settlement period Risk mitigation	**Additional scope exclusions** Loans Credit cards

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5 of these amendments impact non-life application

	Proposed amendment	Practical Implications
Allocation of acquisition costs to expected contract renewals	▸ Allocate part of the acquisition costs—such as commissions paid to brokers—to related expected contract renewals; ▸ Recognise those costs as an asset until the company recognises contract renewals; ▸ Assess the recoverability of the asset at each reporting date; and ▸ Provide information in the notes to the financial statements about changes in the asset during the reporting period; and the expected timing of derecognition of the asset and inclusion of the acquisition costs in the measurement of the expected contract renewals.	▸ Avoid the presentation of some insurance contracts as loss making at initial recognition; ▸ Result in the presentation of a larger longer-lived asset for acquisition costs in the balance sheet; ▸ Actuaries required to model expected renewal profiles for financial reporting? Amendment suggests this deferral is required, not optional.

Reduced accounting mismatches for reinsurance held	▸ A company that recognises losses on loss-making insurance contracts on initial recognition would at the same time also recognise a gain on reinsurance contracts held, to the extent that the reinsurance contracts held:
	    ▸ cover the claims of the insurance contracts on a proportionate basis (ie a fixed percentage of claims is recovered); and
	    ▸ are entered into before or at the same time the loss-making insurance contracts are issued.
		▸ The proposed amendment is expected to result in losses from insurance contracts issued and the recoveries of those losses from proportionate reinsurance contracts held to be recognised in the same period;
		▸ Additional complexity created by narrow scope of reinsurance where this can be applied?

Simplified balance sheet presentation	▸ Proposed amendment to require a company to present insurance contract assets and insurance contract liabilities on the balance sheet using portfolios of insurance contracts rather than groups of insurance contracts.	▸ Expected to reduce complexity in identifying contracts that sit in the asset line vs liability line on the balance sheet. ▸ Groups are expected to move between asset and liability positions (depending on the timing of collection of premiums), most portfolios are expected to be consistently in a liability position.
Additional transition reliefs	▸ In some circumstances a company would be permitted to account for liabilities for claims settlement acquired in a business combination as a liability for incurred claims, rather than as a liability for remaining coverage.	▸ If applied the proposed transition relief will remove impact of a business combination before the date of transition to IFRS 17 on revenue and expenses (resulting in lower number).

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Reinsurance

What are the big challenges?

IFRS 17 – Reinsurance held

Reinsurance contracts held (outwards reinsurance) are **treated as separate contracts** to the underlying insurance contracts issued. This means that the accounting treatment of the reinsurance contracts held is **determined separately** from the underlying insurance contracts issued.

IFRS 17 terminology

Reinsurance held = Outwards reinsurance

Reinsurance issued = Inwards reinsurance

Proportionate coverage = reinsurance recoveries are proportionate to the underlying claims

CONTRACT BOUNDARY is assessed independently for the underlying contracts issued and reinsurance contracts held, which means that the reinsurance contracts held could have a different coverage period to the underlying contracts they cover.

MEASUREMENT of the reinsurance contract held on initial recognition will need to include expected cash flows in relation to all underlying contracts, including those not yet issued – impact for GM contracts only. No impact for PAA contracts.

PAA ELIGIBILITY is assessed independently for the underlying contracts issued and reinsurance contracts held. This means that the reinsurance contracts held could adopt general model when underlying contracts adopt the simplified approach.

LEVEL OF AGGREGATION for reinsurance held is determined separately (and possibly differently) to the underlying contracts issued.

PRESENTATION AND ACCOUNTING for reinsurance held commissions and reinstatements may be accounted for differently depending on their nature.

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Reinsurance type – IFRS 17 definitions

Proportionate reinsurance vs **Non-proportionate reinsurance**

Proportionate reinsurance

Reinsurance recoveries are proportionate to underlying claims – e.g. 20% of each underlying claim in group.

Other ceded cash flows (e.g. premiums, commissions) do not need to be proportionate to the underlying cash flows.

Will include proportional covers – e.g. Quota share

Non-proportionate reinsurance

Everything else.

Some traditionally considered proportional e.g. surplus treaty, non proportional covers – e.g. excess of loss (XOL)

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Reinsurance

What is the contract boundary?

Coverage period of reinsurance contracts

WHAT IS THE COVERAGE PERIOD AND WHY DOES IT MATTER?

How long is the term of the contract for accounting purposes?

Start of the boundary

Defines the point from and up to which contract premiums and related obligations are considered part of the current contract

Within the contract boundary

Coverage period

End of the boundary

Driver of profit recognition

- Premiums are earned over this period

Implications for PAA eligibility

- Coverage period ≤ 1 year automatically eligible
- Becomes more difficult to pass PAA eligibility test the longer the coverage period

APPLICATION TO REINSURANCE

The coverage period is not necessarily the contractual term of the contract. The following contract features will have implications for the coverage period of reinsurance contracts:

TYPE OF COVER

- Losses occurring
- Risks attaching
- Retrospective reinsurance (e.g. ADCs, reinsurance LPTs)

REPRICING AND TERMINATION RIGHTS

- Reinsurer’s right to reprice and existence of conditions/restrictions
- Reinsurer’s ability to terminate and existence of conditions/restrictions
- Cedant’s right to terminate and existence of conditions/restrictions (*outwards reinsurance only*)

OPTIONS TO ADD COVERAGE

- Pricing terms of the option

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Determination of contract boundary (Reinsurance held)

CONTRACT BOUNDARY OF REINSURANCE CONTRACTS HELD

BEGINNING OF CONTRACT BOUNDARY: WHEN TO RECOGNISE CONTRACTS?

PROPORTIONATE COVERAGE

E.g. quota share which will pay in recoveries 20% of claims on each underlying contract

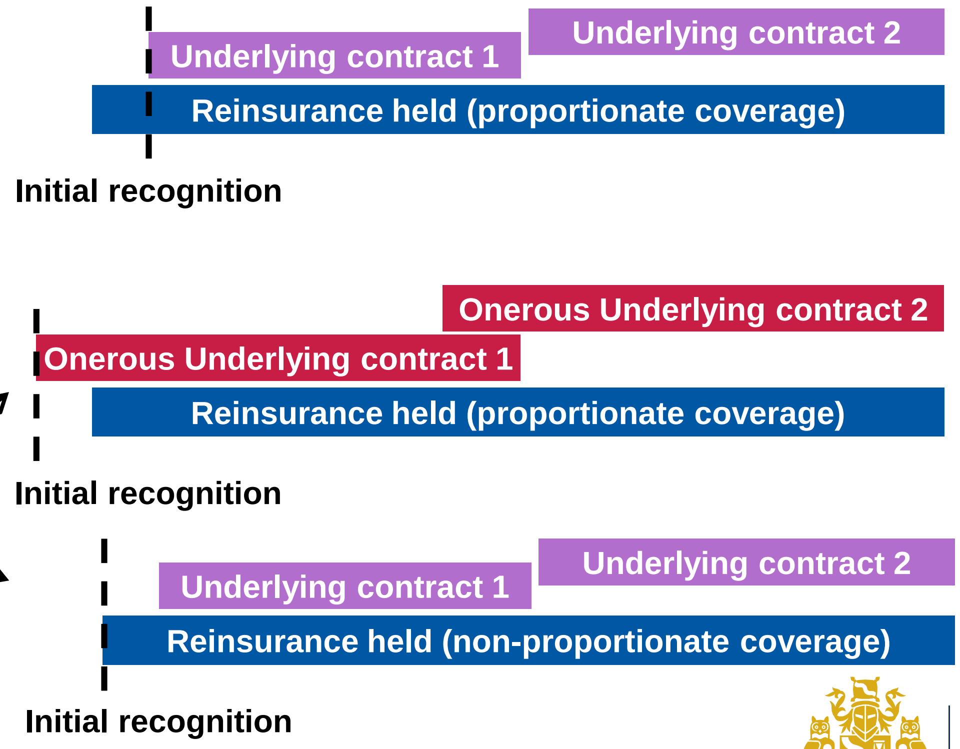
Later of:
(1) beginning of coverage of **group of reinsurance contracts** and
(2) initial recognition of the underlying contracts

Or if recognising onerous group on underlying contracts then at the same time as recognising underlying onerous group.

NON-PROPORTIONATE COVERAGE

E.g. excess of loss contract which will pay in recoveries the amount of underlying claims that exceed CU25m

Beginning of coverage period of the group of reinsurance contracts



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Determination of contract boundary (Reinsurance held)

<u>END OF CONTRACT BOUNDARY</u>: WHEN DO CONTRACTS END?

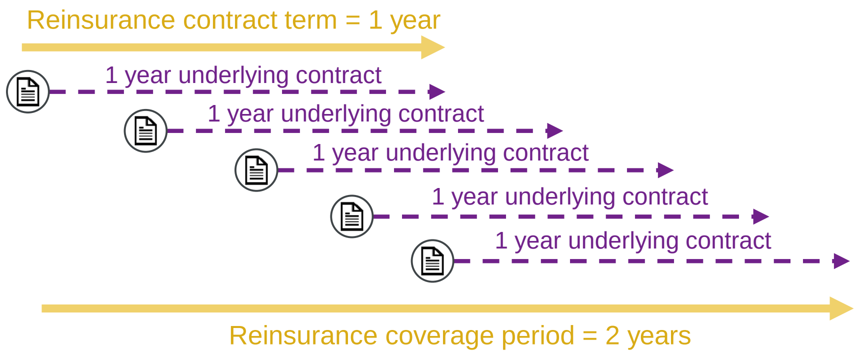
TYPE OF COVER

Losses occurring

- Coverage period likely to be the same as the contract period
- Subject to the existence of repricing and termination rights and options to add coverage

Risks attaching

Coverage period likely to be longer than the contractual term as it will be based on the contract term plus the coverage period of the last underlying contract expected to attach to the reinsurance contract. **Example:**



Retrospective covers

Coverage period is deemed to be the period to the determination of the ultimate cost of claims, which is usually the settlement of those claims

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Determination of contract boundary (Reinsurance held)

END OF CONTRACT BOUNDARY: WHEN DO CONTRACTS END?

REPRICING AND TERMINATION RIGHTS

Both the reinsurer's and the cedant's rights need to be considered.

Consider for:
- *Inwards reinsurance*
- *Outwards reinsurance*

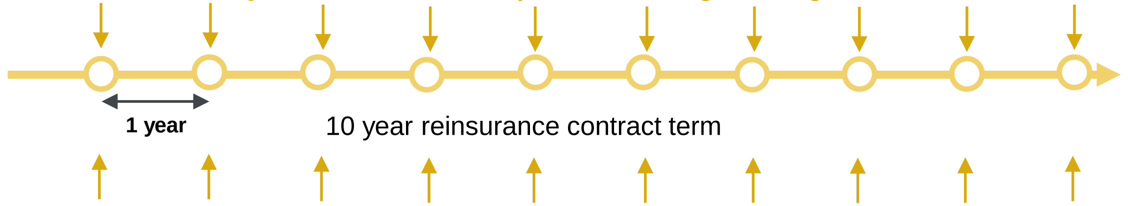
1 **Can the REINSURER reprice or terminate the contract before the end of the contract term?**

2 **Does the CEDANT also have an unconditional right to terminate the contract at that point? , i.e. not only triggered by the reinsurer's decision to reprice**

Consider for:
- *Outwards reinsurance*

Example: A losses occurring inwards reinsurance contract has a contract term of 10 years. At the end of each year, the reinsurer has the ability to reprice (with no restrictions) the remaining coverage of the contract for reassessed risks at that point.

At the end of each year, reinsurer can reprice remaining coverage for reassessed risks



The coverage period for the cedant is 1 year if the cedant also has an unconditional right to terminate the reinsurance contract at the end of each year.

Restrictions to repricing?

Coverage period ends at the point of repricing only if there are no constraints or restrictions to repricing.

E.g. repricing restricted to 2% increase in RWP

Consider whether any restrictions have **commercial substance**. Ignore if no commercial substance

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Determination of contract boundary (Reinsurance held)

END OF CONTRACT BOUNDARY: WHEN DO CONTRACTS END?

Is the option a separate contract in substance?

Where the option is to add a different type of coverage (e.g. motor insurance policy with option to add a home insurance cover), would treating the option as a separate contract reflect the substance of its contractual rights and obligations?

Facts that may indicate that separation is appropriate:

- *components (different coverages) can be priced and sold separately*
- *cash flows related to each coverage are not interdependent*

Separate option and treat as a separate contract

When is the price of the option set?

At inception of the contract

When exercised by the cedant

Pricing is set for the option only.

Pricing is set for the whole contract, i.e. including the option and any remaining coverage on the host contract

Cash flows relating to the option is within the boundary of the host contract

Cash flows relating to the option and remaining coverage is treated as a separate future contract

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Reinsurance

How are RI contracts measured?

IFRS 17 – Measurement of reinsurance contracts held

Same principles as for issued (direct/inwards) contracts but adapted for reinsurance held.

GENERAL MODEL (GM)

Unexpired coverage

- **Contractual service margin (CSM)**
- **Risk adjustment**
- **PV of future cash flows**

Expired coverage

- **Risk adjustment**
- **PV of future cash flows**

Net cost or net gain always recognised on the balance sheet (i.e. not immediately recognised in P&L) unless:

- Retrospective reinsurance
- Proportionate reinsurance covering onerous underlying contracts

Should reflect all expected future cash flows including in respect of **underlying contracts not yet written**

- Should reflect the **risk of non-performance by the reinsurer**
- Should be measured using **consistent assumptions** as those used to measure the underlying contracts to the extent relevant

PAA

- **PAA LfRC**
- **Risk adjustment**
- **PV of future cash flows**

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Reinsurance Held - Risk Adjustment

Gross and Ceded Risk Adjustments are required, rather than just Net Risk Adjustments.

Inwards Risk Adjustment

37. An entity shall adjust the estimate of the present value of the future cash flows to reflect the compensation that the entity requires for bearing the uncertainty about the amount and timing of the cash flows that arises from non-financial risk.

Outwards Risk Adjustment

64. Instead of applying paragraph 37, an entity shall determine the risk adjustment for non-financial risk so that it represents the amount of risk being transferred by the holder of the group of reinsurance contracts to the issuer of those contracts.

Ceded = Gross – Net?

IASB APRIL 2019 TRG CLARIFICATION: Risk adjustment of issued contracts will **reflect the effect of reinsurance (i.e. availability and cost of reinsurance)** if it is considered when determining the compensation required for bearing non-financial risk.

What does this mean? And how should reinsurance be reflected in the measurement of the "gross" risk adjustment?

Three possible outcomes:

- Risk adjustment on inwards contracts a pure gross risk adjustment.
- Risk adjustment on inwards contract reflects a gross risk adjustment adjusted for arbitrage available in reinsurance market.
- Risk adjustment on inwards contracts a net risk adjustment.

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Recognition in the P&L

TREATMENT OF ONEROUS UNDERLYING CONTRACTS

A loss on onerous contracts issued is recognised immediately in the P&L.

TREATMENT OF OUTWARDS REINSURANCE CONTRACTS COVERING ONEROUS UNDERLYING CONTRACTS

Proportionate reinsurance

- Recognise a gain in P&L to the extent the reinsurance contract covers the underlying losses

Non-proportionate reinsurance

- No gain is recognised in P&L immediately. Instead, the gain is held as unearned profit on the balance sheet and recognised in P&L over the coverage period of the reinsurance contract

Accounting mismatch

TREATMENT OF RETROSPECTIVE REINSURANCE

BOTH INWARDS AND OUTWARDS REINSURANCE

- Liability for remaining coverage (unexpired coverage) is earned over the claims settlement period.
- Will result in the recognition of revenue and expenses (income and expenses for outwards reinsurance) over the claims settlement period.

OUTWARDS REINSURANCE

- A net cost on initial recognition is recognised immediately in the P&L

For inwards reinsurance, the treatment of a net gain or net cost will follow the treatment applicable to direct insurance contracts

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Measurement of reinsurance contracts held

TREATMENT OF REINSURANCE CONTRACTS COVERING ONEROUS UNDERLYING CONTRACTS

INITIAL RECOGNITION

ONEROUS UNDERLYING CONTRACTS ISSUED

Premiums	80
Claims	(100)
Loss	**20**

Recognised immediately in P&L

To the extent covered by reinsurance, can we also recognise a corresponding gain on reinsurance in P&L to offset the loss?

It depends on the type of reinsurance cover…

Proportionate reinsurance vs **Non-proportionate reinsurance**

Proportionate reinsurance: **Recognise corresponding reinsurance gain in P&L when losses are recognised**

Tentative decision

Non-proportionate reinsurance: **No reinsurance recognised in P&L when losses are recognised**

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Measurement of reinsurance contracts held

TREATMENT OF REINSURANCE CONTRACTS COVERING ONEROUS UNDERLYING CONTRACTS

CHANGES TO EXPECTATIONS OF ONEROUSNESS AFTER INITIAL RECOGNITION OF THE REINSURANCE CONTRACTS

Will apply when:

- Underlying contracts that were expected to be profitable on initial recognition become onerous
- Underlying contracts that were expected to be onerous on initial recognition become more or less onerous

UNDERLYING CONTRACTS ISSUED

Changes in the underlying cash flows will be reflected in P&L as an onerous loss or a reversal of onerous losses previously recognised

REINSURANCE CONTRACTS HELD

Corresponding changes in reinsurance cash flows will also be reflected in P&L

Applies to ALL reinsurance held – including non-proportional covers

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Reinsurance

Any other accounting challenges?

IFRS 17 - Reinstatement premiums on inwards and outwards reinsurance

IASB SEPTEMBER TRANSITION RESOURCE GROUP (TRG) DISCUSSION

IASB staff considered that there is a distinction in economic substance between mandatory and voluntary reinstatement premiums.

OPERATIONAL IMPLICATION

Will need the ability to **separately identify mandatory and voluntary reinstatement premiums** in order to book them to the relevant premiums / recoveries accounts.

01 Mandatory reinstatement premiums

Reinstatement is compulsory and the cedant does not have the option not to pay the reinstatement premium if triggered.

Treated as part of reinsurance recoveries (not premiums)

02 Voluntary reinstatement premiums

The cedant can decide not to pay the reinstatement premium and terminate the coverage instead.

Treated as part of reinsurance premiums

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Changes to reinsurance accounting

Reinsurance commissions

Not contingent on claims

e.g. commissions based on a % of premiums on the underlying contracts, or % of the reinsurance premiums

Treated as a reduction in premiums

Sliding scale commissions may not be contingent?

Contingent on claims

e.g. profit commissions, NCBs etc

Treated as part of the recoveries to be reimbursed by the reinsurer

Investment components

Commissions contingent on claims (e.g. profit commissions) are likely to have investment components

The amounts that the contract requires the reinsurer to repay to a cedant **in all circumstances** even if an insured event does not occur.

All circumstances include contract termination

Excluded from income and expenses in the P&L

*Need to identify the **amount** of investment component, i.e. the minimum amount that will always be repayable in order to exclude from P&L.*

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Investment Component Example

Fact-set
40% quota-share with sliding Profit Commissions and CU1000 GWP. No other RI, and ignore all other expenses.

Provisional PC = 30%, i.e. CU120

Loss Ratio	PC
30% or below	45%
35%	45%
40%	42.5%
45%	40%
50%	37.5%
55%	35%
60%	30%
65% or above	25%

LR	PC	Recovery	PC	Total	Prov PC	Total less Prov PC
%	%	CU	CU	CU	CU	CU
0%	45%	0	180	180	120	60
5%	45%	20	180	200	120	80
10%	45%	40	180	220	120	100
15%	45%	60	180	240	120	120
20%	45%	80	180	260	120	140
25%	45%	100	180	280	120	160
30%	45%	120	180	300	120	180
35%	45%	140	180	320	120	200
40%	42.50%	160	170	330	120	210
45%	40%	180	160	340	120	220
50%	37.50%	200	150	350	120	230
55%	35%	220	140	360	120	240
60%	30%	240	120	360	120	240
65%	25%	260	100	360	120	240

If no Provisional PC has been paid investment component would have been CU180.

Will receive another CU60 above and beyond Provisional Commission already paid.

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Reinsurance

Wrap up

Reinsurance contract terms – Things to look for…

TERMS THAT WILL HAVE IMPLICATIONS FOR ACCOUNTING UNDER IFRS 17

TYPE OF COVERAGE

- Risks attaching / losses occurring / retrospective reinsurance
- Proportional or non-proportional

REPRICING AND TERMINATION CLAUSES

- Reinsurer’s right to reprice and existence of conditions/restrictions
- Reinsurer’s ability to terminate and existence of conditions/restrictions
- Cedant’s right to terminate and existence of conditions/restrictions

OPTIONS TO ADD COVERAGE

- Pricing terms of the option

CEDING COMMISSIONS

- Volume-based or contingent on claims (e.g. profit commission)
- Existence of investment components, i.e. amounts that would be payable to the cedant in all circumstances

REINSTATEMENT PREMIUMS

- Mandatory or voluntary